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SMALL BUSINESS ADMINISTRATION

13 CFR Part 120

7(a) Loan Program; Eligible Passive Companies

RIN: 3245-AG48

AGENCY: U.S. Small Business Administration.

ACTION: Direct Final Rule.

SUMMARY: This direct final rule amends SBA's existing regulations to clarify the eligible uses of loan proceeds by an Operating Company in connection with an SBA-guaranteed loan to an Eligible Passive Company.

DATES: This rule is effective on [INSERT DATE 45 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] without further action, unless significant adverse comment is received by [INSERT DATE 30 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. If significant adverse comment is received, SBA will publish a timely withdrawal of the rule in the Federal Register.

ADDRESSES: You may submit comments, identified by RIN 3245-AG48, by one of the following methods: (1) Federal eRulemaking Portal: www.regulations.gov; following the instructions for submitting comments; or (2) Mail/Hand Delivery/Courier: Grady B. Hedgespeth, Director, Office of Financial Assistance, U.S. Small Business Administration, 409 Third Street, SW, Suite 8300, Washington, DC 20416.

SBA will post all comments to this rule on www.regulations.gov. If you wish to submit confidential business information (CBI) as defined in the User Notice at www.regulations.gov, you must submit such information to Grady B. Hedgespeth,

Director, Office of Financial Assistance, U.S. Small Business Administration, 409 Third Street, SW, Suite 8300, Washington, DC 20416, or send an email to grady.hedgespeth@sba.gov. You should highlight the information that you consider to be CBI and explain why you believe SBA should hold this information as confidential. SBA will review your information and determine whether it will make the information public or not.

FOR FURTHER INFORMATION CONTACT: Grady B. Hedgespeth, Director, Office of Financial Assistance, U.S. Small Business Administration, 409 Third Street, SW, Suite 8300, Washington, DC 20416; (202) 205-7562; grady.hedgespeth@sba.gov.

SUPPLEMENTARY INFORMATION:

SBA generally makes business loans only to small businesses engaged in regular business activities, and prohibits such assistance to entities engaged in passive investment or real estate development, or which do not engage in regular and continuous activity as an operating business. SBA regulations at 13 CFR 120.111 currently provide an exception to this prohibition on providing financial assistance to passive entities if the passive entity is an Eligible Passive Company that leases real or personal property to an Operating Company for use in the Operating Company's business and complies with the conditions set forth in the regulation. SBA defines an "Eligible Passive Company" or "EPC" as an entity that does not engage in regular and continuous business activity, which leases real or personal property to an Operating Company for use in the Operating Company's business. An "Operating Company" or "OC" is an eligible small business actively involved in conducting business operations now or about to be located on real

property owned by an Eligible Passive Company, or using or about to use in its business operations personal property owned by an Eligible Passive Company.

Section 120.111 requires the Eligible Passive Company to “use loan proceeds to acquire or lease, and/or improve or renovate, real or personal property (including eligible refinancing).” The regulation does not specifically state the eligible uses of loan proceeds for use by the Operating Company, but does require the Operating Company to be a guarantor or a co-borrower (with the Eligible Passive Company) on the loan. In a 7(a) loan including working capital for use by the Operating Company, the regulation requires the Operating Company to be a co-borrower.

When SBA promulgated the current regulations as described above, it offered the following explanation for allowing the Operating Company to be allocated a portion of the loan proceeds in a loan to an Eligible Passive Company:

[I]t is common for an Operating Company to need working capital when the Eligible Passive Company applies for a loan primarily to finance the acquisition of real or personal property. In the past, SBA has required the Eligible Passive Company to use the loan proceeds solely to acquire and improve property for lease to an Operating Company. Thus, two separate SBA loans would be needed – one to the Eligible Passive Company for the real estate and the other to the Operating Company for working capital

(Notice of Proposed Rulemaking published in the Federal Register on December 15, 1995 (60 FR 64356) and Final Rule published on January 31, 1996 (61 FR 3226).) At that time, SBA proposed and finalized a regulatory change to allow a single loan to the EPC to be used, in part, for working capital by the OC, provided the OC is a co-borrower. The loan proceeds for working capital would be allocated to the OC, while the loan proceeds for the acquisition and improvements of the property for lease to the OC would be allocated to the EPC.

The practice of structuring a loan with the real estate held by an EPC that leases the real estate to the OC for operation of its business has become increasingly common. Further, it has come to SBA's attention that many participating lenders have interpreted this rule to allow EPCs and OCs to borrow funds for the OC's purchase of other assets for its use, including the purchase of stock or intangible assets (such as trademarks, copyrights, intellectual property, or goodwill), as long as the OC was a co-borrower with the EPC. SBA recognizes the need for this type of financing. Thus, in order to allow it to continue, SBA is amending 120.111(a)(5) to clarify that if the OC is a co-borrower with the EPC, part of the loan proceeds of a 7(a) loan may be used for working capital or the purchase of other assets for use by the OC, including the purchase of stock or intangible assets (such as trademarks, copyrights, intellectual property, or goodwill). SBA is also amending 120.120(b)(4) to conform with this change.

Because this is a clarifying amendment that is consistent with industry practice, SBA expects no significant adverse comments. Based on that fact, SBA has decided to proceed with a direct final rule giving the public 30 days to comment. If SBA receives any significant adverse comment during the comment period, SBA will withdraw the rule and publish it as a proposed rule.

Compliance with Executive Orders 12866, 12988, 13132, and 13563, the Paperwork Reduction Act (44 U.S.C. Ch. 35) and the Regulatory Flexibility Act (5 U.S.C. 601-612)
Executive Order 12866

The Office of Management and Budget (OMB) has determined that this direct final rule does not constitute a significant regulatory action under Executive Order 12866. This direct final rule is also not a major rule under the Congressional Review Act.

Executive Order 12988

This action meets applicable standards set forth in Sections 3(a) and 3(b)(2) of Executive Order 12988, Civil Justice Reform, to minimize litigation, eliminate ambiguity, and reduce burden. The action does not have retroactive or preemptive effect.

Executive Order 13132

For the purposes of Executive Order 13132, SBA has determined that this direct final rule will not have substantial, direct effects on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. Therefore, for the purpose of Executive Order 13132, SBA has determined that this direct final rule has no federalism implications warranting the preparation of a federalism assessment.

Executive Order 13563

For the purposes of Executive Order 13563, SBA has received meaningful feedback from the industry over the past several months and has held discussions with various participating lenders that have requested this clarification. All of the input SBA has received has been supportive of this clarification.

Paperwork Reduction Act, 44 U.S.C., Ch. 35

SBA has determined that this direct final rule does not impose additional reporting or recordkeeping requirements under the Paperwork Reduction Act, 44 U.S.C., Chapter 35.

Regulatory Flexibility Act, 5 U.S.C. 601-612

The Regulatory Flexibility Act (RFA), 5 U.S.C. 601-612, requires administrative agencies to consider the effect of their actions on small entities, including

small businesses. According to the RFA, when an agency issues a rule, the agency must prepare an analysis to determine whether the impact of the rule will have a significant economic impact on a substantial number of small entities. However, the RFA allows an agency to certify a rule in lieu of preparing an analysis, if the rulemaking is not expected to have a significant impact on a substantial number of small entities. This rule amends existing Agency regulations to clarify the eligible uses of loan proceeds for an Operating Company when it is a co-borrower with an Eligible Passive Company and does not create new requirements. These amendments will affect small entities; however, SBA has determined that these amendments will not have a significant economic impact on a substantial number of such entities.

List of Subjects in 13 CFR Part 120

Community development, Exports, Loan programs-business, Small businesses.

For the reasons stated in the preamble, SBA amends 13 CFR Part 120 as follows:

PART 120 - BUSINESS LOANS

1. The authority citation for 13 CFR Part 120 continues to read as follows:

Authority: 15 U.S.C. 634(b)(6), (b)(7), (b)(14), (h), and note, 636(a), (h) and (m), 650, 687(f), 696(3), and 697(a) and (e); Public Law 111-5, 123 Stat. 115, Public Law 111-240, 124 Stat. 2504.

2. Amend § 120.111 by revising paragraph (a)(5) to read as follows:

§ 120.111. What conditions must an Eligible Passive Company satisfy?

* * * * *

(a) * * *

(5) The Operating Company must be a guarantor or co-borrower with the Eligible Passive Company. In a 7(a) loan that includes working capital and/or the purchase of

other assets, including intangible assets, for the Operating Company's use, the Operating Company must be a co-borrower.

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3. Amend § 120.120 by revising paragraph (b)(4) to read as follows:

§ 120.120. What are eligible uses of proceeds?

* * * * *

(b) * * *

(4) Working capital (if the Operating Company is a co-borrower with the Eligible Passive Company, part of the loan proceeds may be applied for working capital and/or the purchase of other assets, including intangible assets, for use by the Operating Company).

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Dated: March 26, 2012

Karen G. Mills,
Administrator.

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